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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

August 13, 1996

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: CC Docket 96-112: Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services

Dear Mr. Caton:

Today, I delivered the enclosed materials and discussed them with Kathleen Levitz and Andrew Mulitz of the Common Carrier Bureau.

Please include the enclosed materials in the record of this proceeding.

Sincerely,

Larry Fenster

Larry Fenster

Attachments

cc: Kathleen Levitz
Andrew Mulitz

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The Commission Must Adopt Rules Removing Nonregulated Costs From Regulated Accounts

1. **The Commission has a clear statutory obligation to set just and reasonable rates and prevent regulated services from subsidizing nonregulated services.**[1]

   a. Meeting these statutory obligations is the means to achieve the policy goals of advancing video and telephone competition and investment. Unless costs are allocated properly to regulated and unregulated services, the wrong economic signals will be sent and too much or too little will be invested in video and telephony.

   b. Congress did not mandate that OVS be the method by which LECs enter the video market. They only made it available as one of four options. If the Commission fails to allocate enough to nonregulated services, LECs may avoid investing in the least cost video technology. They would also forego improvements in telephone facilities and services they might have made otherwise.

2. **The proposed cost allocation and spare facility rules will not involve financial losses for the LECs.**

   a. The rule should be "whomever bears the risk of the investment should reap the rewards."

   b. Under current rules, nearly all spare facility costs have been allocated to regulated accounts. That may have once been reasonable, since these facilities would eventually be used to provide regulated services, and the revenues from those services could be used to offset regulated rates.

   c. With RBOC entry into long distance and video markets, exchange and exchange access ratepayers will have taken the risk for these facilities, but will not receive the rewards from bearing that risk. Video costs must be removed from regulated accounts, and long distance costs must be transferred to the RBOC separate subsidiary.

   d. Transferring these costs to nonregulated accounts does not impose a financial loss on LEC shareholders. It only imposes risk, and the necessity of realizing a profit. This is the same necessity every competitive company faces every day in the marketplace.

   e. Facing this risk will have a positive effect on the video market. LECs will be motivated to make efficient investments, design creative packages of services, and

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[1] See 1996 Act, Section 653(b)(1)(A); Section 254(k); and Section 201(b).

market them vigorously and creatively.

3. **The magnitude of cross subsidies is quite large, and price caps and other RBOC proposals, will not prevent these misallocations.**

a. The danger of misallocation

I. MCI estimated that Tier 1 LECs have $125 billion worth of spare facilities on their regulated books that are not required to meet the growth in demand for regulated facilities.[2]

ii. This amounts to $17 billion of excess annual costs imposed on regulated customers.

iii. $24 billion of LECs regulated revenues cover facilities, services, and labor that are also used by unregulated services and serve as a source of potential misallocation.

b. Price caps will not prevent misallocations

i. The RBOCs argue that adopting the total productivity factor (TFP) method of calculating productivity will result in productivity factors greater than current productivity factors. Customers will see rate reductions attributable to nonregulated investments, so cost allocation safeguards are not needed.

ii. But when they actually estimate the productivity factor in price cap dockets, they expect the productivity offset to decline by 50%. In actuality, RBOCs expect regulated rates to rise with the use of price caps based on TFP.

iii. RBOCs also propose allocating common costs to nonregulated customers only as the demand for video services materializes. This shifts all investment risk to regulated customers. The RBOCs will be able to build out with a capability of reaching 100% of their target video market without incurring any costs. Then they will incur costs, but only, and exactly, for each subscriber they enroll. This is in complete contrast to competitive firms, which must incur the full cost of building out to meet their target market before signing up a single customer.

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[2]See MCI Comments, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Attachment 1, The Cost of Basic Network Elements: Theory, Modeling and Policy Implications, Prepared for MCI Telecommunications Corporation, Hatfield Associates, Inc., March 29, 1996.

4. **A fixed allocator is based on economic cost causation.** Economists have long argued that non traffic sensitive costs, such as loop, feeder, distribution, and parts of switching costs, are best allocated by means of a fixed allocator. The Commission recognized this basic economic fact in its Notice.

5. **A uniform fixed allocation is administratively simple.**

   a. The 1996 Act requires the Commission to implement its OVS rules within 6 months of its passage. The Commission, following the principle established in its Joint Cost Order that LECs may be free of price regulation for unregulated services if regulated ratepayers do not bear the cost of LEC entry into those businesses, recently granted the LECs complete pricing flexibility for open video carriage rates. Consequently, the Commission must remove nonregulated costs from regulated services as long as it abstains from setting OVS carriage rates.

   b. RBOC suggestions that the Commission needs to build a record that determines the impact of its cost allocation methodology on investment, video competition, and consumer alternatives, will either require modifying the Commission's pricing rules for OVS carriage, or delay LEC entry into video markets.

6. **The Commission may build flexibility into a uniform fixed allocator.** LECs that believe that their unique circumstances justify departing from the uniform fixed allocator may propose alternate allocation methods. The burden of proof must be on the LEC, and the Commission must ensure that LECs provide complete and accurate cost information supporting their request.